Chapter 3

The Maryland State Budget: A Never-ending Deficit Story

Karin Flynn, Ph. D. and Tori Gorman

Despite projections of steady economic and revenue growth, Maryland legislators continue to grapple with a projected long-term structural deficit. Ongoing general fund revenues are expected to grow 25 percent between fiscal years (FY) 2006 and 2011 while ongoing spending will grow 41 percent over the same period. Despite an estimated \$1.3 billion surplus in FY 2006, annual deficits loom in the near future and will grow rapidly, approaching 10 percent of general fund revenue by FY 2011. The cumulative gap between revenues and spending will exceed \$5 billion over the next five years.

With current revenue collections exceeding projections, lawmakers may perceive an opportunity for the state to "grow" out of its structural imbalance and thus avoid any politically unpopular policy decisions. Given current levels of taxation, Maryland total personal income would have to grow more than 9 percent per year initially to close the structural gap—nearly double the current forecast.

Maryland can point to three unique factors that perpetuate its fiscal woes:

1. A revenue structure that fails to keep pace with economic growth
2. The pursuit of generous entitlement policies
3. A leadership deficit

The 2005 Government Performance Project criticized Maryland's tax structure as "antiquated" and evidence suggests this criticism may be valid. Between FY 1990 and 2005, general fund revenue collections averaged 5.1 percent of total personal income. Despite posting strong growth, however, revenues are increasingly falling short of this benchmark. Lackluster performance in the sales and use tax, business franchise taxes, and the lottery relative to regional economic growth are keeping the state from realizing its 'potential' revenue. If achieved, this 'potential' revenue could reduce Maryland's structural deficit by approximately 40 percent.

Spending on local aid to education and entitlements (medical assistance, foster care, assistance payments, and property tax credits) are the largest components of general fund spending and the driving forces behind the state's deficit problem. Spending in these categories grew $1.3 billion between FY 2002 and 2005, and will increase another $3.4 billion by FY 2011, constituting 64 percent of general fund expenditure growth over the forecast period.

Currently, Maryland spends one-third of its general fund on aid to local K-12 education. Education is the single largest expense category and has grown 59 percent since FY 2002. Spending growth has been fueled primarily by provisions in the 2002 Bridge to Excellence Act. Unfortunately, it remains unclear whether the state's explosive investment in K-12 education is yielding proportionate results, and the accuracy of performance tests is questionable. Already, Maryland's per-capita K-12 education spending is increasing much faster than elsewhere in the nation and neighboring states. Left unchecked, aid to local education will consume 36 percent of the general fund budget by FY 2011, crowding out other spending priorities.

With one in ten residents enrolled in Medicaid or the Maryland Children's Health Program, medical assistance is the state's second largest spending category, comprising 15 percent of the general fund budget. Expenditures are projected to increase at an annualized rate of 7 percent, significantly outpacing revenue growth. Although children represent a majority of enrollment growth, costs largely are driven by long-term care for elderly, disabled, and dual Medicaid-Medicare eligible individuals. Without fundamental changes, Maryland will spend nearly one-fifth of its general fund budget on medical assistance by FY 2011—a budget crisis sure to be exacerbated by the impending retirement of the baby boom generation.

Maryland actually suffers from *twin* deficits: a structural deficit and a leadership deficit. Both the executive branch (including the current and past administrations) and the legislature seem unwilling to make the tough choices necessary to balance limited resources with spending priorities, and instead have relied on temporary fixes to plug the breach. The size and scope of estimated future deficits, however, make the continuance of this practice virtually impossible. Political leadership will be vital to steer the state through its budget challenge.

In light of the Maryland's persistent struggle with a deepening structural deficit, lawmakers should:

1. **Recapture lost 'potential' revenue.** Maryland should re-think its reliance on gambling revenues either by replacing the lottery with an alternative (i.e., personal property tax), or by enhancing lottery revenues with additional gaming (casinos, slot machines, etc). In addition, the state should examine the decline in the sales and use tax and business franchise taxes (relative to historical norms) and make the necessary adjustments to recapture the lost base.

2. **Reform Medicaid.** Under the federal Deficit Reduction Act of 2005 (P.L 109-171), Congress gave states new latitude to alter Medicaid benefits, restructure cost sharing, emphasize preventative care, expand the role of private insurers, and encourage patients to take more personal responsibility for their health care decisions. Program managers should use the flexibility bestowed by the federal government to retool Medicaid and reduce spending.

3. **Reform education and education testing.** Lawmakers should address the inconsistencies in school performance testing so they can properly and accurately assess whether increased spending has resulted in improved scholastic achievement. With over one-third of education spending targeted for Baltimore City and Prince George's County, the resultant lackluster academic performance suggests the education infrastructure in these jurisdictions needs to be fundamentally changed. Aggressive non-profit funding and support should be sought to alleviate the cost to the state of overhauling the school systems in low-income and/or underperforming jurisdictions.

4. **Minimize the opportunity cost of the Rainy Day Fund.** Bond rating agencies place such priority on Rainy Day Funds (and their balance) that the current administration has been unwilling to tap into the fund, even in times of need. The opportunity cost of this money,

especially given Maryland's fiscal outlook, is significant (over $600 million in FY 2006). Budget officials should recognize the purpose of the Rainy Day Fund and use it prudently, but without fear of impunity.

5. **Reduce, abolish, or re-evaluate spending agreements on perennial money-losing ventures.** Maryland taxpayers help fund several ventures with questionable value. Individually, none of these reforms will contribute significant amounts toward reducing the structural deficit, but saving nickels and dimes can go a long way toward making ends meet.

6. **Enhance budget discipline.** Maryland has adopted several procedures aimed at achieving budget stability, including: five-year revenue and spending projections; a spending affordability process; and a well-managed reserve fund. But more is needed. Specifically, lawmakers should consider establishing five-year discretionary spending caps; adopting PAYGO requirements; and promulgating entitlement 'triggers' to check mandatory spending growth.

MARYLAND'S PERSISTENT STRUGGLE WITH STRUCTURAL DEFICITS

Despite projections of steady economic and revenue growth, Maryland legislators continue to grapple with a projected long-term structural deficit. Although the Department of Legislative Services estimates that cash balances are sufficient to cover the *operating* deficits projected in FY 2007 and 2008, future spending commitments to education and health care, as well as sizable unfunded retirement benefit liabilities, will result in significant *structural* deficits that threaten the state's spending priorities.[1]

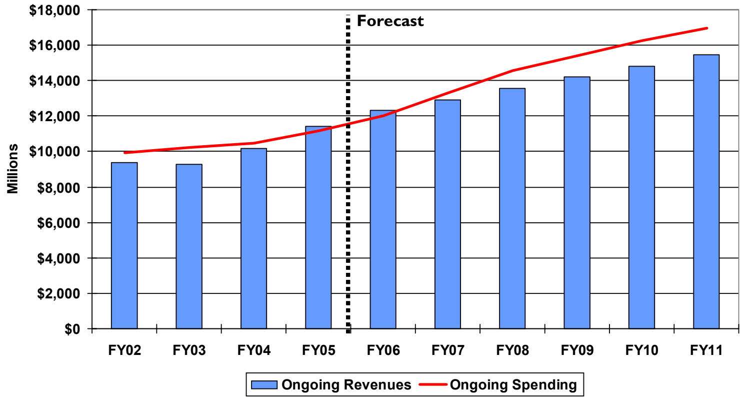
According to the Comptroller's Board of Revenue Estimates, ongoing general fund revenues are expected to grow 25 percent between FY 2006 and 2011 while ongoing spending will grow 41 percent over the same period (see Figure 1). While state coffers currently are flush with excess cash—analysts predict FY 2006 will close with a $1.35 billion surplus—the predicted imbalance between revenues and expenditures

1. A structural deficit is defined as the difference between ongoing revenues and ongoing spending, whereas an operating deficit includes one-time, or temporary, revenues and expenditures.

Figure 1

Maryland Continues to Struggle With a Structural Deficit

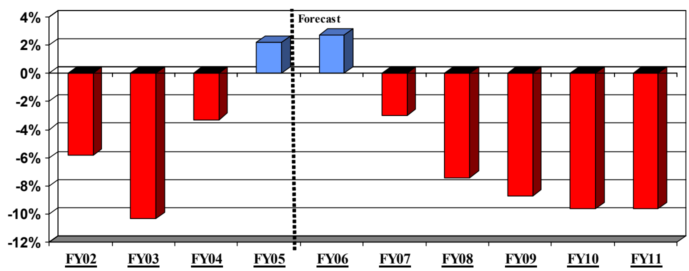
General Fund Revenues and Spending FY2002-FY2011



Source: Department of Legislative Services, *90-Day Report*, April 2006

Figure 2
Short-term Surplus Gives Way to Significant Structural Deficits

General Fund Structural Balance, Percent of General Fund Revenues



	FY06	FY07	FY08	FY09	FY10	FY11	Total FY06-FY11
Ongoing Revenues ($M)	$12,339	$12,924	$13,539	$14,190	$14,821	$15,452	
Ongoing Spending ($M)	$12,010	$13,315	$14,543	$15,428	$16,245	$16,935	
Structural Balance*	$330	($391)	($1,003)	($1,238)	($1,425)	($1,483)	($5,210)

* Note: Does not include unfunded liabilities: injured workers, $235 million; retiree healthcare, between $13.0 and $20.4 billion; and retiree pensions, $4.5 billion

Source: Department of Legislative Services, *90-Day Report*, April 2006 will generate persistent, sizeable deficits totaling $5.2 billion over five years.

The state's battle with structural deficits is not new. The failure of ongoing revenues to keep pace with ongoing spending was a factor in the mid-1990s too. However, lawmakers have been lucky beneficiaries of robust economic and revenue growth. Moreover, officials have been able to use fees, fund transfers, and other gimmicks to plug annual shortfalls. With current projected out-year deficits reaching nearly 10 percent of general fund revenues, deficits will rapidly become too large to paper over and will require lawmakers to promulgate a multi-year plan to bring spending in line with revenue projections (see Figure 2).

Other 'competitor' states have risen to the perennial challenge of balancing spending priorities with limited resources more effectively than Maryland. While Maryland defers structural changes in favor of one-time, stop-gap measures, Virginia, Delaware, and Pennsylvania all have proactively addressed budget imbalances by making tough choices concerning tax and spending priorities (see Figure 3).

Economic Growth Alone Cannot Resolve the State's Fiscal Imbalance

With current revenue collections exceeding projections, lawmakers may perceive an opportunity for Maryland to 'grow' out of its structural imbalance and thus avoid any politically unpopular policy decisions. Given the state's only relatively robust economic forecast, however, this appears unlikely.

For nearly two decades the Maryland economy has weathered significant changes. The decline of manufacturing and downsizing of the federal government have eroded the protective barrier that insulated the state's jobs base from business cycle fluctuations. Recessions in 1980-1981 and 1990-1991 had significant and long-lasting effects on the regional economy. In the 1970s and 1980s, Maryland employment grew an average of 2.6 percent per year, but in the decades following, job growth dropped by two-thirds to an annual average of 1.1 percent (see Figure 4). Income growth followed suit, falling from an average of 9.5 percent in the 1970s and 1980s, to an average of 5.2 percent per year between 1990 and 2005 (see Figure 5).

The regional economic forecasts that underpin the state's revenue projections—a consensus forecast prepared by the Maryland Board of Rev-

Figure 3
Competitor States Earn Higher Grades for Budgeting

VIRGINIA: There is little that Virginia does not do well in government management. That's been true for a while. But it keeps looking for improvements, and very often finds them. The state used a compendium of budget maneuvers to navigate through fiscal storms of the last few years. With an eye to maintaining its long standing excellent credit rating, Virginia worked hard at budget balancing and with success. In 2004, the General Assembly passed tax reform that has helped keep the state's finances in solid shape.
Government Performance Project Grade: A

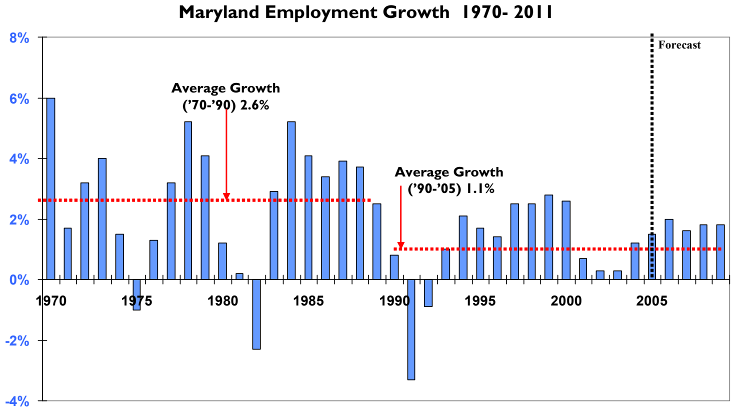
DELAWARE: Delaware's tax structure has proven to be "quite recession proof," officials say. The state survived well through the budget crisis of recent years, avoiding the use of one-time measures to patch budget gaps. To navigate through tight budget times, the state increased tax collection enforcement, increased and/or added fees or charges, and did some debt refinancing. In 2004, the state also made some tax changes. There was a cigarette tax increase, an increase in the corporate franchise tax, and a change in the distribution of video lottery proceeds. The state froze hiring, made spending cuts, and initiated program reorganization in 2003 and 2004. Delaware's pensions are fully funded. Government Performance Project Grade: A

PENNSYLVANIA: Pennsylvania maintains good budget vision and does well in supporting structural balance. The state has fully or nearly fully-funded pensions and manages its finances with discipline; for example, unlike many states, Pennsylvania did not tap its tobacco settlement funds to reach balance. In fact, the state conducted many routine revenue and spending actions in order to maintain budget balance.
Government Performance Project Grade: B+

MARYLAND: Maryland's tax structure has been termed "antiquated." However, the state did enact changes to individual and corporate income taxes in FY 2005 that are expected to bring in an additional $66 million. Proposed revenue actions in FY 2004 and again in 2005 did include changes to certain taxes and fees that bring in additional revenues. Maryland has a revenue stabilization fund; the state transferred $533 million to the general fund as a revenue adjustment. While the state has accessed this fund to balance the budget in recent years, it has been good about replenishment. Maryland used other revenue strategies to reach budget balance, such as accelerating revenues, including altering the timing of income tax withholding and changing withholding of property gains for residents living outside the state.
Government Performance Project Grade: B

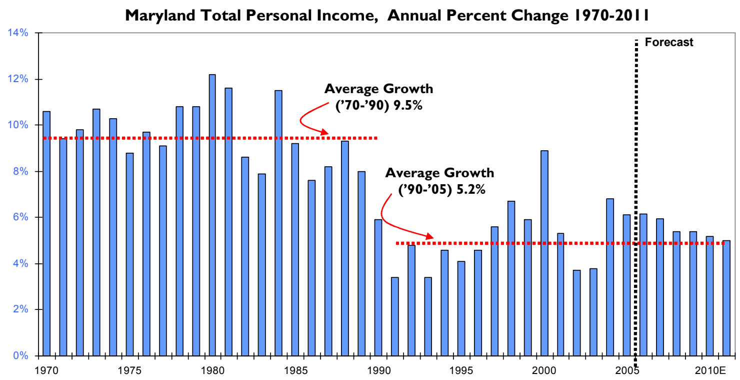
Source: The 2005 Government Performance Project

Figure 4
Maryland Employment Growth Slowed Markedly in the 1990s



Source: U.S. Bureau of Labor Statistics

Figure 5
Growth in Personal Income Followed Suit



Source: US Bureau of Economic Analysis

enue Estimates (BR²E) —call for job and income growth in excess of the 15-year historical average (see figure 6):

Figure 6
Maryland Economic Forecasts are Robust

Annual % Change In:	ACTUAL '03	'04	'05	'90-'05 AVG	FORECAST '06	'07	'08
Total Non-Agricultural Employment	0.4	1.1	2.0	1.1%	2.0	1.6	1.8
Total Personal Income	3.8	6.8	6.3	5.2%	6.4	5.5	5.3

Source: Maryland Board of Revenue Estimates, December 2005

Given current levels of taxation, Maryland total personal income would have to grow more than 9 percent per year initially to close the structural gap—nearly double the current forecast (see figure 7).

Figure 7
Personal Income Growth Needed to Close the Deficit

CAGR*	2007	2008	2009	2010	2011	
Structural Balance (DLS, April '06, $M)	(391)	(1,003)	(1,238)	(1,425	1,483)	
Total General Fund Rev. to Eliminate Deficit ($M)	13,321	14,526	15,403	16,233	16,937	
Current General Fund Rev./ % of MD Total Personal Income	5.06%	5.02%	4.99%	4.96%	4.93%	
Total Personal Income to Close Gap ($M)	263,450	289,434	308,754	327, 317	343,596	
% Change in Total Personal Income (Prior Year)	9.1%	9.9%	6.7%	6.0%	5.0	6.9%

*CAGR: Compound annual growth rate

2. The Board of Revenue Estimates is comprised of the State Comptroller, the State Treasurer, and the Secretary of Budget and Planning.

Clearly, economic growth alone cannot resolve the state's fiscal imbalance.

Three Factors Perpetuate Maryland's Structural Deficit

Although Maryland is not the only state grappling with scarce resources, it can point to three unique factors that perpetuate its fiscal woes. First, the state maintains a revenue structure that cannot keep pace with regional economic growth. Despite steady growth in total personal income, recently collections from several large revenue sources have fallen short of historical averages. As a result, Maryland is not achieving its full 'potential' revenue.

Second, Maryland has adopted generous entitlement policies that act as a brick on the accelerator that controls spending. Mandated benefit programs such as Medicaid and local aid to education alone account for nearly two thirds of the spending growth between now and FY 2011. Compounding this problem will be the first wave of Baby Boomers opting for retirement.[3]

Lastly, the state suffers from a lack of effective leadership. Both the executive branch (including the current and past occupants of the post) and the legislature seem unwilling to make the tough choices necessary to balance limited resources with spending priorities, and instead have relied on temporary fixes to plug the breach. The size and scope of estimated future deficits, however, make it virtually impossible for this practice to continue.

Maryland's "Antiquated" Revenue Structure Is Not Capturing Economic Growth

Part of Maryland's budget struggles can be attributed to a revenue structure that has not kept pace with economic growth. *The 2005 Government Performance Project* criticized Maryland's tax structure as "antiquated" and evidence suggests this criticism may be valid. One way to examine this hypothesis is to compare the ratio of general fund revenues (and component revenue sources) to total personal income. Revenues that grow in line with income will generate a consistent ratio that fluctuates little over time. Revenues that fail to capture regional growth will

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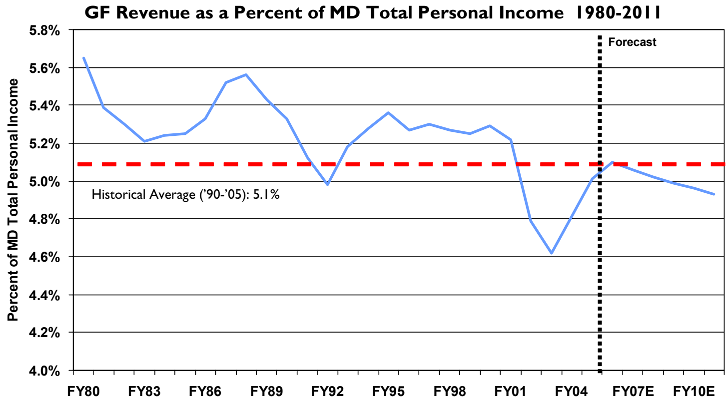
3. The first Baby Boomers will be eligible for Social Security in 2008 and for Medicare in 2011.

Figure 8

General Fund Revenues are Falling Short of Historical Averages



Source: Maryland Public Policy Institute, April 2006

result in a ratio that declines persistently. Changes in tax policy will produce a one-time shift in the ratio between revenues and total personal income, but as long as revenues grow in line with income, the new ratio should remain steady over time.

Between FY 1990 and 2005, general fund revenue collections averaged 5.1 percent of total personal income. Recently, however, revenues have increasingly fallen short of this benchmark suggesting that Maryland's revenue structure is not keeping pace with regional economic growth (see Figure 8). In light of the state's dismal fiscal outlook, there is a significant opportunity cost to lawmakers' inability to halt the erosion of Maryland's tax base.

A closer examination of the major sources of the general fund reveals that lackluster performance in the sales and use tax, business franchise taxes and the lottery relative to regional economic growth keep Maryland from realizing its 'potential' revenue:[4]

- Between FY 1990 and 2005, sales and use tax revenue—Maryland's second largest revenue source—averaged 1.41 percent of total per-

4. "Potential" revenue is defined as the revenue the state would have collected under the current tax structure if all revenue sources achieved and maintained their historical ratio relative to state total personal income.

sonal income. Since FY 2002, however, the ratio has declined consistently. BRE projections of sales taxes imply this ratio will continue to under-perform the historical average over the forecast period (see Appendix A.2).

- Between FY 1990 and 2005, revenues from the state lottery, Maryland's third largest revenue source, equaled an average of 0.24 percent of total personal income. In FY 1999, lottery revenues fell below the statistical norm and have maintained their downward trend ever since. BRE predicts lottery revenues will average 0.19 percent of total personal income between FY 2006 and 2011 (see Appendix A.3).

- Business franchise taxes averaged 0.12 percent of total personal income between FY 1990 and 2005. Since FY 1996, however, the growth in business franchise taxes has not kept pace with personal income and the ratio has steadily declined. BRE predicts franchise taxes will hover around 0.08 percent of total personal income between over the forecast period.

Interestingly, the individual income tax is not a culprit (see Appendix A.1). Despite recent reductions in the tax rate, individual income tax collections continue to grow on pace with personal income.

These revenue sources fail to keep pace with regional economic growth for various reasons. The Maryland lottery faces increased competition from multi-state mega-jackpot lotteries and casino-style gambling in Delaware and New Jersey, as well as from on-line gambling. Moreover, players of lottery games typically are low-income individuals who have not benefited from recent economic gains. Stagnant revenue from public service companies and declining revenue from telecommunications companies due to Internet telephony competition are a drag on business franchise tax revenue. Reasons for the decline in sales tax revenues relative to income growth are less clear, but may have to do with tax cuts (exemptions and rate reductions), tax holidays, vendor discounts and Internet sales.

While divergence of revenues from historical collection ratios may seem small, they amount to millions of dollars. Indeed, achieving and maintaining 'potential' revenues would reduce Maryland's structural deficit by approximately 40 percent (see Figure 9).

Figure 9

Achieving and Maintaining 'Potential' Revenues Would Eliminate Approximately 40% of the Structural Deficit

MD General Fund Revenue Opportunities and Impact on Projected Shortfall FY06-FY11

	FY 2006E	FY 2007E	FY 2008E	FY 2009E	FY 2010E	FY 2011E	Total '06-'11
Current GF Estimate ($M)	$12,339	$12,929	$13,523	$14,165	$14,808	$15,454	$83,219
"Potential" GF Revenue * ($M)	$12,383	$13,120	$13,824	$14,567	$15,319	$16,085	$85,298
Difference ($M)	$44	$190	$301	$402	$511	$631	$2,079
Estimated Shortfall ($M)	N/A	$391	$1,003	$1,238	$1,425	$1,483	$5,210
Percent of Shortfall		48%	30%	32%	36%	43%	40%
Memo: Maryland Total Personal Income ($M)	241,370	255,718	269,449	283,939	298,584	313,510	

* Note: "Potential" revenue is achieved by maintaining historical levels of taxation vis-à-vis total personal income

Maryland's Pursuit of Generous Education and Entitlement Policies

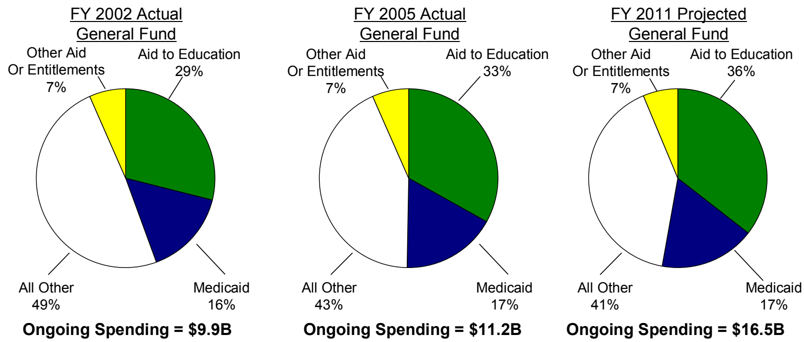
Spending on local aid and entitlements are the largest components of Maryland's general fund spending and contribute significantly to the deficit problem (see Figure 10). Local aid and entitlement expenditures, combined, grew $1.3 billion between FY 2002 and 2005 and will increase another $3.4 billion by FY 2011—representing 64 percent of the increase in the general fund budget over the forecast period.

Aid to local K–12 education and Medicaid are both the largest programs and the only two contributing to the expense growth among local aid and entitlement expenditures as a percentage of general funds (also Figure 10).

Several factors underpin the local aid and entitlement spending problem:

- **National trend:** Entitlement spending across the nation, at all levels of government, is increasing faster than overall spending (per-capita spending too).
- **Maryland's generosity:** Maryland's per-capita spending is increasing much faster than that of the nation and neighboring states.

Figure 10
Primary General Fund Expense Growth Categories



Note: Percentages may not add to 100% due to rounding.
Source: Department of Legislative Services: 90-Day Report April 14, 2006; 90-Day Report April 11, 2003.

- **Inner city plight:** Baltimore City and Prince George's County have structural problems that do not seem to improve in accordance with increased spending.
- **Little fundamental change:** Expenditures have not been re-addressed in light of inconclusive improvements (e.g., education) and shifts in demographics (e.g., Medicaid spending on the elderly and disabled).

Aid to Local Education: The Elephant in the Room

One-third of Maryland's general fund budget will be spent on aid to local education and libraries during FY 2007. Already in 1998, at 31 percent, this was the largest ongoing spending category of the general fund, although in absolute terms the state's education budget has more than doubled since then and will reach $4.5 billion in FY 2007. After 1998, education aid slowly decreased to 29 percent of spending in 2002, the year the final report of the Thornton Commission on Education—"Finance, Equity and Excellence"—was released.[5]

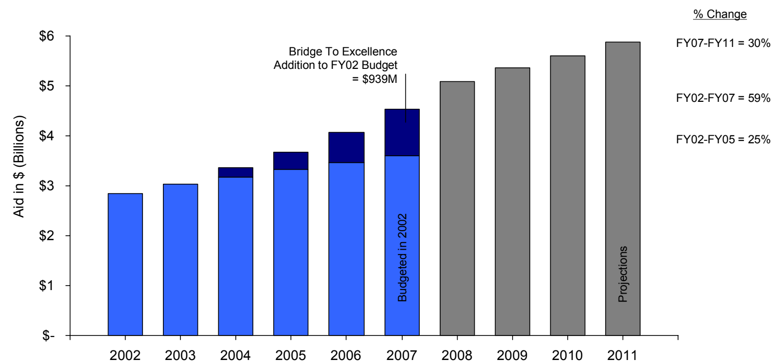
5. Department of Legislative Services, *90-Day Report*, April 11, 2003; p. A-38.

The Impact of the Bridge to Excellence Act

The Bridge to Excellence in Public Schools Act of 2002 decidedly reversed the downward trend in education spending. This legislation codified the recommendations of the Thornton Commission and mandated a $1.3 billion increase in state education funding by FY 2008.[6] Accordingly, state spending on local aid to education and libraries is slated to rise 59 percent ($939 million) between FY 2002 and 2007. Despite this increase, funding levels will still fall short of the commitments recommended by the Thornton Commission (see Figure 11).[7]

Figure 11

General Fund Spending on Local Aid to Education and Libraries 2002-2011



Source: Department of Legislative Services: 90-Day Report April 14, 2006; 90-Day Report April 11, 2003;

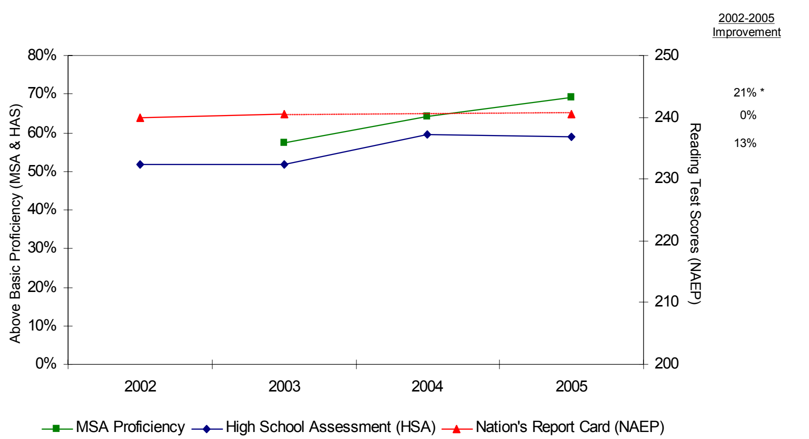
The primary goals of the Bridge to Excellence Act are to 1) enable local school systems to receive the resources needed to reasonably expect that students can meet academic performance standards, and 2) replace all education funding with flexible, wealth-equalized block grants from formulas that are based on adequacy concepts. Unfortunately, it is impossible to assess clearly how much Maryland's K–12 education has improved with the increase in state spending, or know whether it is on target to meet the Thornton Commission goals. As seen in Figure 12, the apparent improvements depend on which test is used to measure

6. Department of Legislative Services, Commission on Education, "Finance, Equity and Excellence," Final Report, January 2002.
7. The planned increase represents 84 percent of recommended funding levels.

educational performance. Student scores on the Maryland School Assessment (MSA) have improved 21 percent since 2003, but academic performance measured by the NAEP (National Assessment of Education Progress) is flat.

Maryland's State Department of Education acknowledges these discrepancies, but argues that the NAEP results are not fair or accurate because, among other reasons, "in the absence of a national curriculum from which to develop a national standard, a national test such as NAEP does not accurately represent what is actually taught—and learned—in the classroom."[8] The discrepancies are so substantial, however, that they cannot and should not be ignored.

Figure 12
Maryland Education Test Scores 2002–2005



NOTE: All numbers reported are averages of all categories and grades measured in each test type respectively; e.g., MSA Proficiency numbers show the Average of Grade 3, Grade 5 and Grade 8 scores for Reading and Math.
Source: 2004 & 2005 Maryland Report Card; NAEP Nation's Report Card

None of the goals of the Bridge to Excellence Act have been clearly met. For example, by 2005 (the most recent year for which education test scores are available), the state's education budget had increased 25 percent, but by all measures has not seen a concomitant increase in academic achievement. Moreover, state spending on education remains disaggregated: in FY 2007, Howard County will receive $3.2 million in state funding for special education students enrolled in non-public insti-

8. Department of Legislative Services, Issue Papers, 2006 Legislative Session, p. 62.

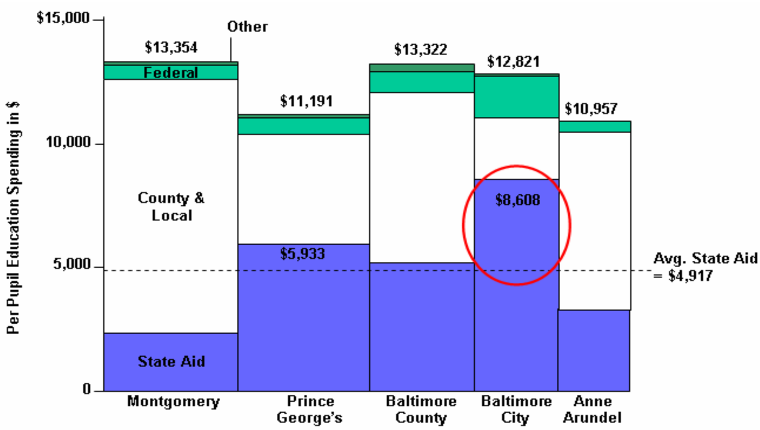
tutions; and a second program will provide $428,000 for the Math and Science Partnership.[9]

Education in Baltimore City and Prince George's County

With three-quarters of all Maryland schools in need of improvement (as determined by "No Child Left Behind") located in the Baltimore City and Prince George's County, it is no surprise that general fund spending on local education is concentrated in these two jurisdictions.[10] Maryland will spend one-third of its FY 2007 education budget in Prince George's County ($798 million) and Baltimore City ($734 million) alone.

In these jurisdictions, state aid provides over half of the resources necessary to cover the costs of educating children in grade K-12 (see Figure 13). Baltimore City receives 67 percent of its education aid from the State of Maryland and raises only 19 percent locally. Maryland's contribution, over $8,600 per student, alone represents $315 million in general fund spending for FY 2007. Although Prince George's County raises

Figure 13
Total Per-Pupil Education Spending by Source of Revenue FY 2007



NOTE: Width of bar represents number of pupils in state, area of bar represents total state aid.
Sources: Fiscal Year 2007 School Systems Superintendent's or Education Board's Proposed Operating Budgets available on School Systems Websites (http://www.marylandpublicschools.org/MSDE/schoolsystems/System_Links_County.htm)

9. Howard County, Fiscal 2007 Board of Education's Budget Request, pp. Restricted-24 & Restricted-26.
10. Department of Legislative Services, Issue Papers, 2006 Legislative Session, p. 63. Ninety-six schools in Baltimore City and 72 schools in Prince George's County have been classified as needing improvement.

Figure 14
Education Performance in Baltimore City and Prince George's County

NOTE: All numbers reported are averages of all categories and grades measured in each test type respectively; e.g., MSA Proficiency numbers show the average of Grade 3, Grade 5 and Grade 8 scores for Reading and Math.
Source: 2004 & 2005 Maryland Report Card; Department of Legislative Services Issue Papers – 2006 Legislative Session.

significantly more funds locally (40 percent), the state's contribution of $5,933 per student accounts for $137 million of Maryland's general fund expenditures in 2007.

Improvement in Baltimore City's and Prince George's school systems is debatable (Figure 14). While MSA test scores have improved faster than other jurisdictions, these two localities still fall below the state average. Moreover, NAEP scores conflict with the MSA data. Lastly, high school assessment scores have showed little improvement and are 42 percent lower than the state average. The lack of appreciable improvement in high school performance is particularly discouraging for Baltimore City, since its total per-pupil funding is almost equal to that of much wealthier Montgomery County.

The Teacher Pension and Retirement System

Senate Bill 1019/House Bill 1737, passed during the 2006 legislative session, further increases the cost of aid to local education. This bill enhances pension benefits for all members of the Teachers' Pension System (TPS) and the Teacher's Retirement System (TRP), and requires a Joint Commission on Pensions to re-evaluate state pension plans every five years.[11] In FY 2007, $446 million (or 10 percent of the cost of edu-

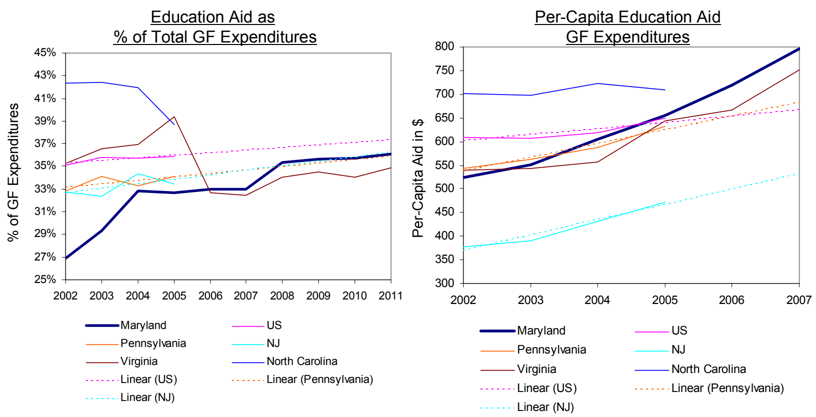
11. Department of Legislative Services, "90 Day Report," April 14, 2006, p C-18.

cation aid) correspond to teacher retirement programs.[12] The new legislation increases pension benefits by 8.5 to 28.5 percent depending on when a teacher retires, and is retroactive to 1998.[13] Because the state is responsible for paying the full employer share of that liability for all teachers, in FY 2008 Maryland will spend an additional $61 million on teacher retirement.[14]

Education Spending in Maryland and Other States

A comparison with regional competitors reveals that other states dedicate a larger portion of their budget to education funding, but that Maryland spends more on a per-pupil basis (see Figure 15). By 2007 Maryland will spend about $125 or almost 20 percent more per resident on K-12 education than the U.S. average.

Figure 15
Education Spending in Maryland and Neighboring States



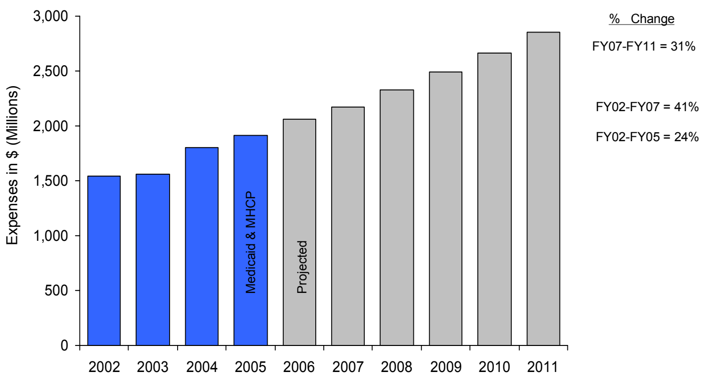
NOTES: Last year of data available for all states is 2005. The fast increase in per-capita spending results from a slow population growth (5% between 2002-2007) while Education Aid General Fund expenditures are projected to grow 59% between FY02-FY07.
Source: NASBO 2003 and 2004 Expenditure Reports, State of Virginia Department of Planning & Budget Six Year Financial Plan (FY06-FY12)

12. *Ibid.*, p. L-2.
13. *Ibid.*, p. C-19.
14. *Ibid.*, pp. A-68 and C-20, and Department of Legislative Services, Issue Papers, 2006 Legislative Session, p. 45. Assumes education-related retirement expenses are 58 percent of Maryland's GF retirement expenditures as in FY 2006 when $406.9 million was spent on teacher retirement, $432.7 million on total local government retirement, and $268 million on total state employees retirement.

Medicaid: Every Governor's Problem

More than one-in-ten Maryland residents are enrolled in Medicaid.[15] By FY 2007, Maryland will spend $2.17 billion (or 16 percent) of its general fund budget on health care for children and low-income families, making it the second largest category of spending.[16] Medicaid and MCHP expenditures are projected to increase $627 million by FY 2007, an average annual increase of 7 percent over FY 2002 levels driven by "enrollment increases of about 2 percent, changes in medical inflation/utilization (6.5 percent), and a variety of policy and program modifications. Enrollment growth is spurred by a continued rise in the number of children qualifying for Medicaid due to their low incomes."[17] This trend is expected to continue unabated, thus adding another $683 million to the budget by 2011 (Figure 16).

Figure 16
General Fund Medicaid and MCHP Spending Growth 2002–2011



Note: 2008-2011 projections are based on FY2007 Legal Appropriations published in the 2006 90 Day report and Medical Assistance Expenditure Growth Rates assumed in the 2006 Issue Papers forecast for 2008-2011.
Source: Department of Legislative Services: 90-Day Report April 14, 2006; 90-Day Report April 11, 2003; Issue Papers 2006 Legislative Session, Dec 2005.

15. Department of Legislative Services, Issue Papers, 2006 Legislative Session, p. 115. The Kaiser Commission on Medicaid and the Uninsured (www.kff.org/mfs/medicaid.jsp?r1=MD&r2=US) reports it at a slightly lower 9.2 percent for 2004.
16. Department of Legislative Services, "90 Day Report," April 14, 2006, p. A-34.
17. Department of Legislative Services, Issue Papers, 2006 Legislative Session, p. 114.

Medicaid Spending Growth Drivers

Generally, growth in Medicaid can be attributed to two primary components: enrollment growth and health care costs. Enrollment growth, in turn, is affected by demographic changes, regional economic growth (or lack thereof), and changes in Medicaid eligibility rules. Health care costs are driven by inflation, utilization, and regulation.

Maryland's high Medicaid expenditures are driven by most of these factors. The creation of MCHP in 1998 has caused most of the growth in Medicaid enrollment.[18] Recently, however, enrollment growth has slowed to 2 percent per year compared to 12 percent in 2000 and 2002.[19] Anemic economic growth also played a role.

Maryland's Medicaid eligibility is among the most generous in the U.S. Most of the state's eligibility criteria are at least 50 percent broader than the national average and could expand even further. For example, Maryland has proposed to enhance primary care and mental health services for low-income uninsured adults and the buy-in program for the working disabled, hoping that matching funds and projected savings will only require $11 million of new general funds.[20]

Health care costs are high and rising. The FY 2007 budget includes $52 million in rate increases for many service providers.[21] Expenses are also rising due to regulatory changes. Although the new Medicare prescription drug program will relieve state Medicaid programs of the responsibility of providing prescription drug coverage, state budgets will not perceive any savings. Federal legislation creating the new Medicare benefit contains a 'clawback' provision requiring states to remit an amount equivalent to the costs that they would have incurred to continue the prescription drug coverage through Medicaid to the federal government.[22]

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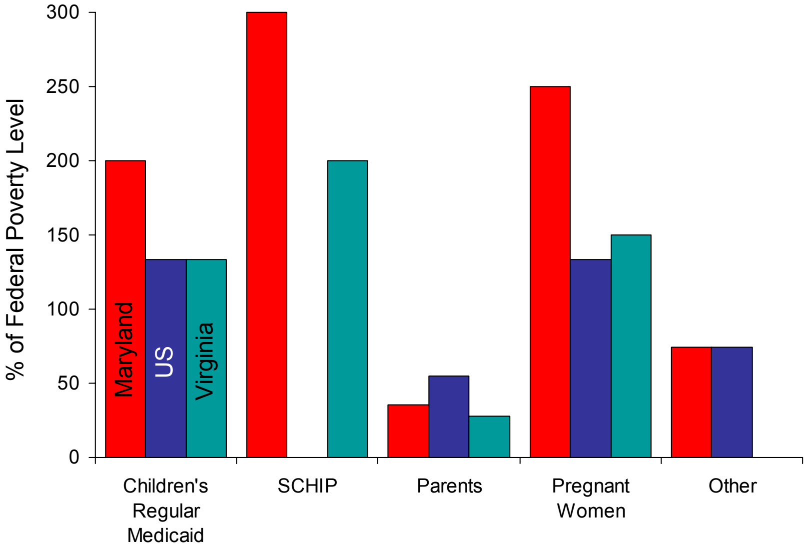
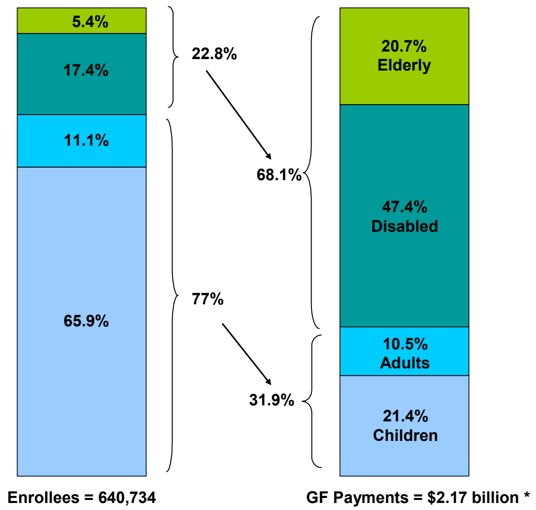
18. Maryland Department of Health and Mental Hygiene, *Maryland Medicaid at a Glance*, January 2004.
19. Maryland's Department of Human Resources, "DHR Fact Pack 2004, Medical Assistance."
20. Department of Legislative Services, Issue Papers, 2006 Legislative Session, p. 114.
21. Department of Legislative Services, "90 Day Report," April 14, 2006, p. A-17.
22. Department of Legislative Services, Issue Papers, 2006 Legislative Session, p. 114.

Figure 17
Maryland Medicaid Eligibility Criteria 2005



Source: Source: State Health Facts, Kaiser Family Foundation, http://www.statehealthfacts.org

Figure 18
Maryland's Distribution of Medicaid Expenditures FY 2007



NOTES: * Payment distribution based on FY2003 percentages.
Source: Maryland Department of Health and Mental Hygiene, January 2004;
The Henry J. Kaiser Family Foundation "Medicaid's High Cost Enrollees: How Much Do They Drive Program Spending?", April 2006

But by far, the largest driver of Medicaid costs in Maryland and the U.S. as a whole is the disproportionate cost of care for the elderly, disabled, and dual Medicaid-Medicare eligible individuals. In 2007, $1.5 billion (or 68 percent) of Maryland's general fund Medicaid spending will be for the elderly and disabled, despite the fact that they represent only 23 percent of the state's Medicaid enrollees (see Figure 18).

Similarly, only about 11 percent of Maryland's Medicaid population is eligible for both Medicaid and Medicare, but these individuals consume 30 percent of the state's Medicaid expenditures.[23] This problem is not unique to Maryland. Across the U.S., on average, 69 percent of Medicaid expenses are for the elderly and disabled, although they only represent 25 percent of the U.S. Medicaid population.[24]

Long-term care of elderly, disabled and dually-enrolled Medicaid patients is the largest single expense in providing health care for low-income individuals. In the U.S., one of every two dollars spent on nursing homes is paid by Medicaid. In Maryland, long-term care represents 70 percent of all elderly and 39 percent of all disabled Medicaid expenses. The state will spend $719 million—one-third of its general fund Medicaid budget—on long-term care in FY 2007.[25] Controlling Medicaid expenditures will pivot on how the state pays for long-term care.

Medicaid in Baltimore City

Structural poverty and the number of uninsured in Baltimore must be addressed when reigning in Medicaid costs. One-third of Baltimore's residents are enrolled in Medicaid, more than twice the national average (see Figure 19). While poverty and the uninsured are common challenges among inner city populations, Baltimore's plight seems extreme. For example, only 26 percent of Detroit's population is enrolled in Medicaid.[26] If Baltimore City's Medicaid enrollment percentage mirrored the

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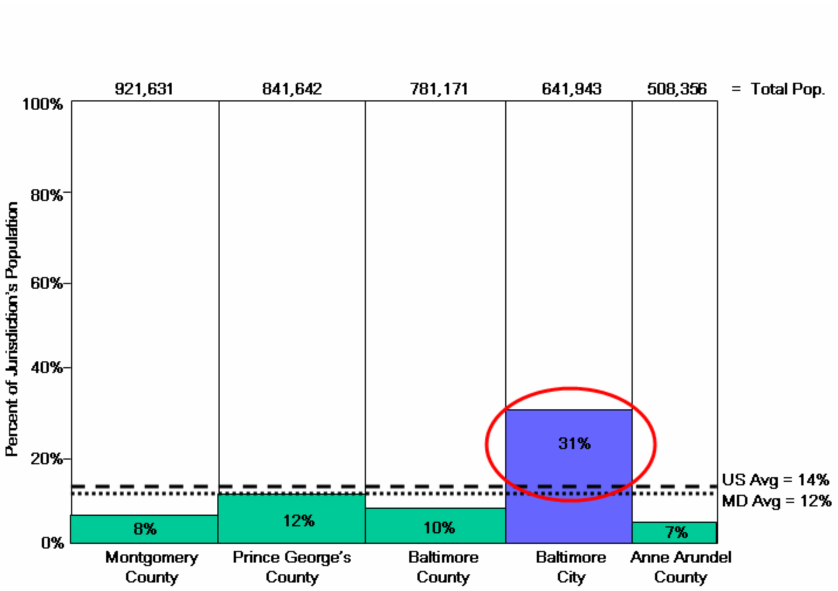
23. The Kaiser Commission on Medicaid and the Uninsured, www.kff.org/mfs/medicaid.jsp?r1=MD.
24. The Henry J. Kaiser Family Foundation, "Medicaid + Medicare at 40: Key Medicaid and Medicare Statistics," www.kff.org/medicaid/40years.cfm.
25. *Ibid.*, and Maryland Department of Health and Mental Hygiene, *Maryland Medicaid at a Glance*, January 2004, assuming the same long-term care expenditures relative to total spending for each of Maryland's elderly, disabled, and dual eligible as for the U.S. as a whole.
26. Report of the Detroit Health Care Stabilization Workgroup, "Strengthening the Safety Net in Detroit and Wayne County," August 2003.

U.S. average of 13.9 percent or Maryland's average of 12 percent, the state's general fund Medicaid expenditures could be $350 million to $380 million lower in 2007.[27]

Figure 19
Medicaid Enrollment by Jurisdictions FY 2004

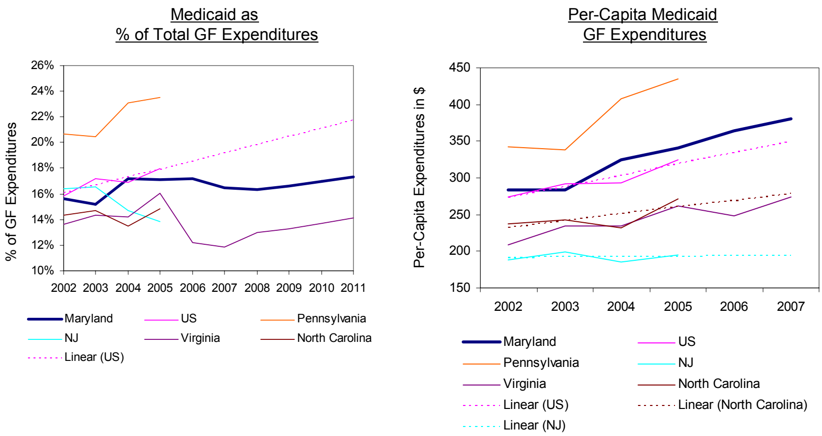


Medicaid Spending in Maryland and Other States

The rising cost of providing health care for the poor is a budget challenge for policy makers across the nation, but Maryland compounds the problem by maintaining generous benefits and a broad scale of income eligibility. As a result the state has one of the highest costs per enrollee in the nation (see Figure 20). Maryland dedicates a smaller portion of its overall budget to Medicaid than other competitor states, but its per capita spending is somewhat higher—roughly $90 (per person) more than Virginia's and $25 more than the U.S. average.

27. Assumes $629 million or 29 percent of the Medicaid GF Budget (or $1.33 billion total) is spent on Baltimore City; sample savings estimate for the cost of only 12 percent enrollment: if 31 percent enrollment costs equal $629 million then 12 percent equal $250million, leading to savings of $349 million.

Figure 20
Medical Assistance Spending in Maryland and Neighboring States



NOTE: Last year of data available through NASBO is 2005.
Source: NASBO 2003 and 2004 Expenditure Reports, State of Virginia Department of Planning & Budget Six Year Financial Plan (FY06-FY12)

The Impact of the 2005 Deficit Reduction Act

Title VI of the 2005 Deficit Reduction Act (P.L 109-171) opened the door for Medicaid reform. The legislation grants states more flexibility to change benefits, increase cost-sharing and premiums for patients, expand the role of private insurers, and instill further self-reliance in its beneficiaries.[28] With this newly granted flexibility, many states have already jumped at the opportunity to implement changes to their Medicaid programs.[29]

Maryland has been a proponent of long-term care reform since 2004. The state's solution—CommunityChoice—centers on the concept of "community care organizations." Building on the success of the home and community-based services waiver, these organizations are intended to be financially motivated to offer cost-effective alternatives to nursing homes for a greater percentage of Medicaid and all dual eligible beneficiaries.[30] Maryland has applied for a federal waiver authorizing a pilot program of CommunityChoice that will be rolled out in late FY 2007 at

28. Congressional Budget Office Cost Estimate, S. 1932 Deficit Reduction Act of 2005, p. 34.
29. "State Changes Reshape Medicaid," *The Washington Post*, June 12, 2006, pp. A1 and A13.

the earliest.[31] Whether or not this approach turns out to be the right solution, the wheels are in motion to address the Medicaid expenditure issue with solutions that will be more structural than one-time fiscal year fixes and carryovers.

MARYLAND'S SECOND DEFICIT: LEADERSHIP

Maryland actually suffers from *twin* deficits: a structural deficit and a leadership deficit. The path lawmakers walked to reach this budget scenario is marked with negligence, political gamesmanship, and a dearth of leadership. Both the executive branch (including the current and past administrations) and legislative branch of government are complicit. In this year alone:

- In a nod to election year politics, Governor Robert L. Ehrlich, Jr. submitted an FY 2007 budget that significantly exceeded the Spending Affordability Committee recommendations.
- Despite looming out-year deficits, the Spending Affordability Committee raised its recommendation for spending growth from 8.9 percent to 9.57 percent based not on need but on better-than-expected revenue growth.
- Although the state carries significant unfunded pension liabilities, the legislature agreed to increase teacher and state employee retirement pay, exacerbating Maryland's entitlement problem.

Resolving Maryland structural imbalance should not be difficult as a practical matter. The problems are easily identified and the remedies are readily obvious. Political leaders should make the tough choices and encourage other lawmakers to follow.

30. Maryland's Department of Health and Mental Hygiene, "Community Choice: Maryland's New Vision for Long Term Care," www.dhmh.state.md.us/mma/communitychoice/index.html.
31. Department of Legislative Services, Issue Papers, 2006 Legislative Session, p. 123.

RECOMMENDATIONS

Recapture Lost 'Potential' Revenue

The failure of Maryland's second and third largest revenue sources to keep pace with regional economic growth is a significant finding and should encourage a re-examination of the state's revenue structure. Specifically, Maryland should re-think its reliance on gambling revenues either by replacing the lottery with an alternative (i.e., personal property tax), or by enhancing lottery revenues with additional gaming (casinos, slot machines, etc). In addition, the state should examine the decline in the sales and use tax and business franchise taxes (relative to historical norms) and make the necessary adjustments to capture the lost base.

In 2002, the General Assembly convened a panel to examine the state's fiscal structure. The Commission met repeatedly throughout the year but adjourned before a final report could be issued. The Commission should be resurrected and its recommendations brought before the legislature for consideration.

Reform Medicaid

Under the Deficit Reduction Act of 2005, the federal government gave states new latitude to alter Medicaid benefits, restructure cost sharing, emphasize preventative care, expand the role of private insurers, and encourage patients to take more personal responsibility for their health care decisions. In 1997, Maryland was one of the first states to operate Medicaid under a managed care waiver, demonstrating its commitment to innovative thinking. Program managers should use the flexibility bestowed by the federal government to retool Medicaid and reduce spending.

Among changes being implemented in other states, the following may be worth considering in Maryland: [32]

- **Privatize part of the state's Medicaid system (Florida).** Under this approach the state subsidizes health insurance rather than health care, thus carrying less of the risk. Recipients will be able to choose from a selection of health plans (19 in Florida). A similar approach was adopted this year in Massachusetts.

32. "State Changes Reshape Medicaid," *The Washington Post*, June 12, 2006, pp. A1, A13.

- **Subsidize small-company insurance plans (Arkansas).** An alternative to subsidizing health insurance for Medicaid eligibles, subsidies to small-companies are intended to ultimately reduce Medicaid enrollment.

- **Increase co-payments (Kentucky).** Although Kentucky is raising co-payments for most adults, Maryland could take a more progressive approach based on the poverty level of the recipient. In particular, the state's eligibility criteria are more generous than most across the nation, and thus covers individuals with better economic resources (133 to 300 percent of the federal poverty level).

- **Establish health savings accounts and rewards (South Carolina).** These accounts and rewards offer an alternative to co-payments for increased cost-sharing with recipients.

- **Institute "Member Agreements" (West Virginia).** In these agreements Medicaid recipients agree to keep doctor's appointments, take prescribed medications and not overuse emergency care. Patients who either refuse to sign or do not follow the agreements will be eligible for less care.

Long-term care reform is critical if the creeping cost of state-wide medical assistance is to be controlled. Some of the recommendations above may indirectly address long-term care, but other alternatives must be considered since private insurance covers on average only 8 percent of long-term care[33]. Maryland's *Community-Choice* program is one of them. Further negotiations with the federal government regarding cost-sharing from patient's social security payments is another.[34]

Baltimore City's Medicaid enrollment also needs to be addressed. Although enrollment has fallen from 37 percent in 1997 to 29 percent in 2004, it still exceeds the national and state averages by a factor of three. The only long-term solution to this problem is addressing chronic poverty and the high number of uninsured residents.

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33. The Henry J. Kaiser Family Foundation, "Medicaid + Medicare at 40: Key Medicaid and Medicare Statistics," www.kff.org/medicaid/40years.cfm
34. Based on the analogy that healthy Social Security recipients must pay rent and living expenses with their Social Security benefits.

Reform Education and Education Testing

The state should reevaluate Maryland's Student Assessment (MSA) Proficiency Testing. This test's results are so incongruous with those of the National Assessment of Education Progress (NAEP) that the problem cannot be ignored. Without accurate testing, Maryland cannot assess whether the high aid to local education spending is actually improving the quality of education.

The Bridget to Excellence Act focused entirely on how to provide funding for schools. Not surprisingly, much more than money is needed to transform underperforming schools and their communities. The Governor's Commission on Quality Education[35] in part addresses this issue. Of its 30 recommendations, 13 focus on issues related to hiring, retention, and flexibility for high-quality teachers and principals. However, only three directly address education change in low-income areas, and these are limited to parent and community involvement, as well as charter schools.

A different and remedial infrastructure is needed to better educate children in low-income areas. Such infrastructure does not only include meals and support for early childhood education, as already in place or planned. It must also offer after school care, one-on-one tutoring and homework assistance, ongoing psychological counseling, long-term relationship building with college-graduate role models, and even temporary legal housing and job search and skill development help for families in transition. Some of these improvements can be patterned after non-profit programs such as "I Have a Dream."[36]

Non-profit aid for education reform and the implementation of new school models for low-income jurisdictions should be aggressively pursued. Above-average state spending in Baltimore City and Prince George's County will amount to $450 million of FY 2007 general fund spending, yet they receive very limited non-profit support. For example, "I Have a Dream" has four projects in the District of Columbia but none in Maryland.[37] To date, the Bill and Melinda Gates Foundation has invested about $1 billion in education initiatives, of which only $13.8 million (1.4 percent) have benefited K-12

35. Governor's Commission on Quality Education, September 2005 Report, Lt. Governor Michael Steele, Chairman, pp. 12–17.
36. www.ihad.org.
37. www.ihad.org/projects_detail.php?statedetail=Maryland

education in Maryland. By contrast, Chicago has received $46.6 million and New York $125 million.[38]

Minimize the Opportunity Cost of the Rainy Day Fund

Like many states, Maryland is statutorily required to maintain a Reserve Fund (Rainy Day Fund) equal to 5 percent of estimated general fund revenues to help mitigate the budgetary impacts of any spending and revenue surprises. But bond rating agencies place such priority on the fund (and its balance) that the Ehrlich administration has been unwilling to tap into the funds, even in times of need:

> The importance which the bond rating agencies place on maintaining a Rainy Day Fund balance of at least 5 percent of the estimated general fund revenues has changed the practical use of the Rainy Day Fund. Even during times of fiscal distress, maintaining a balance equivalent to 5 percent of general fund revenues is treated as a necessity. Thus the reserves are not available to meet the statutory goals for the fund. For the Rainy Day Fund to again serve as a short-term revenue source in times of distress, a balance in excess of 5 percent is required.[39]

Essentially, Maryland is sitting on millions of dollars that the Governor refuses to use. Given the state's fiscal outlook, the opportunity cost of these 'sunk' funds is significant (over $600 million in FY 2006). Budget officials should recognize the Rainy Day Fund as the resource it is designed to be and use it prudently, but without fear of impunity.

38. Bill and Melinda Gates Foundation, Education Program Fact Sheet, www.gatesfoundation.org/Education/RelatedInfo/EducationFactSheet-021201.htm; Maryland data were obtained by contacting the Foundation.
39. Maryland General Assembly, "2005 Spending Affordability Committee Report," December 2005, p. 7.

Reduce, Abolish, or Re-evaluate Spending Agreements on Perennial Money-losing Ventures

Maryland taxpayers support several ventures with questionable value. Individually, none of these reforms will contribute significant amounts toward reducing the structural deficit. But as every household knows, saving nickels and dimes go a long way toward making ends meet. Therefore, lawmakers should review taxpayer-funded support of the following facilities:

- **Rocky Gap Golf Course and Conference Center.** Currently, Rocky Gap does not generate enough cash flow to service the interest payments on its debt, including $8.4 million in public loans. Moreover, in the past, Rocky Gap has been forced to borrow short-term funds to cover payroll during slow months. Although Rocky Gap's losses narrowed this year (to $4.6 million from $5.3 million), the facility remains unprofitable after eight years in operation. Staff at the Department of Legislative Services (DLS) have repeatedly suggested that lawmakers consider options if Rocky Gap continues to post losses.

- **Baltimore City Convention Center.** The state's obligation to fund part of convention center's operating deficit ends in 2008. According to current budget estimates, Maryland's portion of this agreement amounts to $5.4 million in FY 2006 and $4.8 million in 2007. A Maryland Stadium Authority (MSA) task force studying the convention center agreement recommends continued state funding if convention marketing improves. The task for has rejected recommendations for new funding options (at least for now) including an increased hotel room tax despite the fact that most competing states use such a tax to fund their convention centers. DLS staff has recommended that the MSA comment on additional financing options and whether new marketing efforts have yet affected convention center bookings.

- **Oriole Park at Camden Yards.** The Maryland Stadium Authority (MSA) is required to pay rent to the state equal to the difference between actual revenues and actual expenses. In FY 2005, the MSA posted a net operating loss and no rent payment was made. Projections of MSA revenues and expenses predict additional losses and it is expected that the MSA will be unable to make any rent payments in FY 2006 and 2007 as well—a loss to the general fund of approximately $3 million per year.

- **Chesapeake Bay Conference Center.** Financed with $12 million in revenue bonds by the Maryland Economic Development Corporation (MEDCO), the CBCC has been in operation since 2002 yet remains unprofitable. In 2004, the Maryland General Assembly promulgated a 2.5 percent hotel surcharge to service the construction debt, yet operating revenue remains insufficient to repay principal and interest. DLS staff have requested that MEDCO brief legislative committees on when net operating income will be sufficient to initiate debt repayment.

Enhance Budget Discipline

Virtually all states have some requirement, either statutory or constitutional, for a balanced operating budget. Maryland sets limits on spending through the spending affordability process to ensure revenues meet expenditures. In addition, the state has access to a reserve fund to ease budget pressures during economic downturns. Both the executive and legislative branches include five-year forecasts of the budget indicating they have an interest in the long-term. But more is needed. Specifically, lawmakers should consider:

- E**stablish Five-year Discretionary Spending Caps.** Lawmakers in Maryland are prone to spend to the limit without an eye for the future (notwithstanding the state's Rainy Day Fund which is well-managed). Witness the Spending Affordability Committee's decision to increase FY 2007 spending authority not based on need, but on the premise that more money was simply available to spend. By adopting multi-year spending caps, lawmakers would be forced to 'bank' any surpluses, apply them to unfunded liabilities, or pay down debt.

- **Adopt PAYGO Requirements.** "PAYGO" is shorthand for "pay as you go" and refers to a budget discipline that requires any new tax cut or spending increase to be offset. By adopting PAYGO requirements, lawmakers would be required to 'pay' for tax cuts or any new spending with revenue enhancements or other program reductions. Regulations could be drafted such that PAYGO requirements could be waived under certain circumstances such as national emergencies and/or supermajorities in both chambers.

- **Promulgate Entitlement 'Triggers' to Limit Mandatory Spending.** As part of the legislation creating the Medicare prescription drug program, the federal government instituted a

Medicare 'trigger' such that if general revenues comprise over 45 percent of Medicare expenditures, the President is required to submit legislation to Congress containing proposals on how to reduce Medicare spending. Maryland lawmakers should consider similar triggers for education, Medicaid, and other entitlement programs.

APPENDIX

Figure A.1

General Fund Revenues – Individual Income Tax Trend Relatively Constant

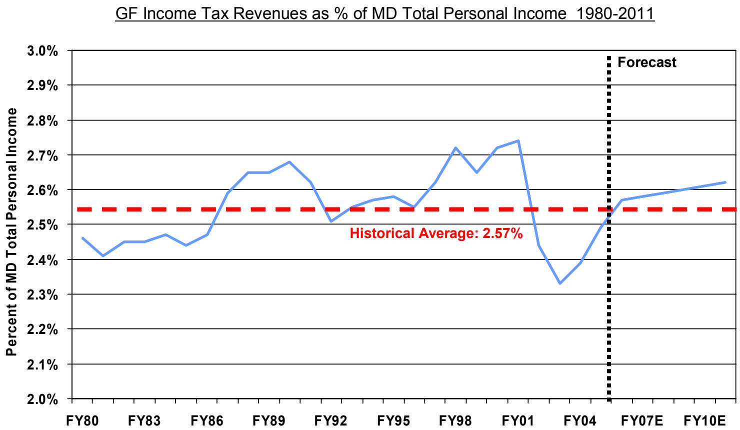

Figure A.2

Sales and Use Taxes are a Drag on "Potential" Revenues

Sales and Use Tax Revenues as a Percent of MD Total Personal Income 1980-2011

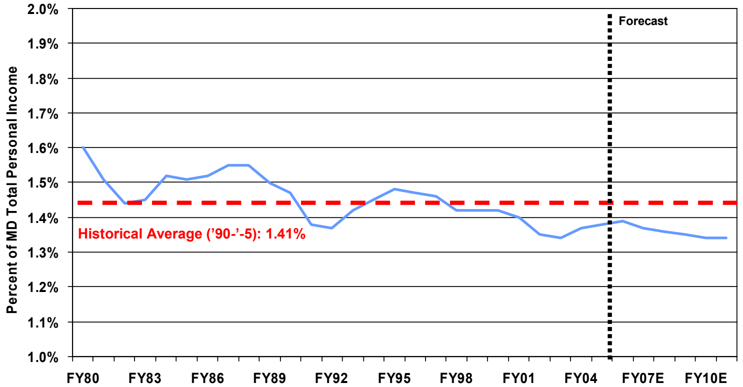

Figure A.3

Lottery Revenues Continue Their Steady Decline

Lottery Revenues as a Percent of MD Total Personal Income 1980-2011